Life changes immediately and drastically for a commercial mortgage loan on the day it is sold into a securitization. Gone are the days where the lender could accommodate the borrower’s requests to alter the terms of the original lending arrangement. No more can the lender and the borrower simply work things out. There are new rules. And lots of them. Tax rules, securities laws and ERISA regulations just to name a few. New and exotic documents like Pooling and Servicing Agreements (to which the borrower is not even a party) impose a sometimes rigid framework in which the securitized loan will be serviced and its future determined.

Not that these new rules and documents don’t have a legitimate purpose. The basic goal of the securitization structure is to ensure the unfettered flow of funds from the underlying real estate securing the loans to the certificateholders owning fractional, undivided beneficial interests in the loans. This goal is achieved by pooling the loans in a trust vehicle under the supervision of a trustee and managed by professional servicers: a “master servicer” to handle day to day matters while the loans perform and a “special servicer” with respect to non-performing loans. Collectively, these parties now stand in the shoes of the former lender.

When a securitized loan is performing, the rules generally (but not always) foster a harmonious and cooperative environment in which the master servicer services the loans, the trustee directs the funds generated by the loans from Point A (the borrowers) to Point B (the certificateholders) and the special servicer “stands by” to deal with problems and certain more complex servicing issues like approving major assumptions and modifications. All is right with the world.

But what happens in times of trouble? What will happen in the real world when a securitized large loan stops performing? The purpose of our yarn is to explore how, in troubled times, the complex, “high performance” structure of a securitization could malfunction under the stress of nonperformance. We will look at the securitization of a large loan because it is in the
securitization of these loans in which the urge to utilize elaborate structures to achieve multifarious business objectives is most unrestrained. In these transactions, the interest of many financially powerful constituencies must be served and complexity in the service of these interests is not only tolerated but celebrated. As our story unfolds, please bear in mind that, to make a point, we have ascribed fairly Machiavellian motivations to the players but, of course, this is a work of fiction.

With that in mind, we submit for your consideration, our cautionary tale…

A Cautionary Tale

Once upon a time there was a real estate developer, called No-Fault Developers, Inc. (“No-Fault”). No-Fault needed to refinance the existing debt on its Class-A office tower (which it values at $280 million) located in the City of Metropolitania (the “Property”), so it turned to the capital markets. No-Fault needed a lot of proceeds, and it approached Risk Taker Capital Inc. (“Risk Taker”), the real estate lending arm of a prominent investment bank. No-Fault had success with Risk Taker in the mid-90’s, and the president of No-Fault was, in fact, the golfing buddy of one of Risk Taker’s powerful bankers. Risk Taker and No-Fault executed a commitment letter pursuant to which Risk Taker agreed to lend No-Fault $230 million, almost $30 million more than anyone else (and lots more than those pesky, conservative life insurance companies that No-Fault borrowed from in the late 90’s, when life was good and they regularly met his demands). Pursuant to the commitment letter, Risk Taker would advance $190 million in a first mortgage loan secured by the Property (the “Mortgage Loan”), and would advance the balance of the $230 million under a mezzanine tranche (the “Mezzanine Loan”), secured by a pledge of equity in the first mortgage borrower.

A. The Initial Financing

In due course, the financing closed. The mortgage borrower is a typical, rating agency-compliant, single purpose, bankruptcy remote, single member Delaware limited liability company, dubbed No-Fault SPE, LLC (the “Borrower”). The sole member of the Borrower is a No-Fault affiliated limited liability company, NF Member, LLC (“NF Member”). The documents securing the Mortgage Loan (the “Mortgage Loan Documents”) are standard securitization documents for large loans. They were heavily negotiated with some wins for the lender and some wins for the borrower, but nothing the rating agencies or, indeed, any subordinate bond buyer would reject out of hand. The Mortgage Loan Documents provide for a “springing” cash management regime where, if the Borrower should be in default of its obligations under the Mortgage Loan Documents or if the debt service coverage ratio for the Property falls below 1.20x, Risk Taker will use pre-signed tenant direction letters to redirect rent checks to a lockbox account controlled by lender.

The Mortgage Loan is non-recourse to the Borrower, but contains standard non-recourse carveouts for “bad boy” acts (including a voluntary bankruptcy). No-Fault has executed a guaranty over some of these non-recourse carveouts (but not bankruptcy), pursuant to which it
is liable for the intentional fraud and similar misconduct of the Borrower. Risk Taker made

certain to negotiate into the Mortgage Loan Documents the right to require the Borrower to

submit budgets and other detailed financial reporting, and the right to kick out the manager of the

property once a default occurs. The Mortgage Loan Documents also provide that the Borrower

will be responsible for certain fees payable to rating agencies and other parties for approval of

certain actions requested by the Borrower in the event that the Mortgage Loan is sold into a

securitization.

The ownership chart of the No-Fault entities resembles the electrical engineering

schematic for a nuclear power plant—various constituencies of the No-Fault parent entity feed

into other No-Fault entities, including NF Property Management II, LLC (“NF Manager”), the

building manager. NF Manager appears to know what it’s doing, although it almost exclusively

manages No-Fault owned buildings.

Risk Taker believes its Mezzanine Loan is also “typical” (i.e., it looks like the last

mezzanine deal that counsel for Risk Taker put together last year), and is secured by NF

Member’s pledge of 100% of its equity interest in the Borrower.

B. The Best Laid Plans…

Of course, Risk Taker never intended to hold this financing until maturity. In

fact, its exit strategy for both the Mortgage Loan and Mezzanine Loan was conceived long

before the commitment was ever inked with No-Fault. Within a few weeks of closing the

financing, Risk Taker sets its plans into action:

1. Participation of the Mortgage Loan.

At the closing table, the Mortgage Loan was split into (i) a $140 million senior

tranche (the “A Note”) destined for securitization and (ii) a $50 million subordinate tranche (the

“B Note”), for the time being, to be held by Risk Taker. A draft of a Co-Lender and Servicing

Agreement (the “Co-Lender Agreement”) was readied by Risk Taker’s attorney. The Co-Lender

Agreement is to be executed by Risk Taker, as holder of the B Note, and the securitization trust,

as the holder of the A Note, and sets forth their relative rights and obligations.

2. Securitization of the A Note.

Within a few weeks of the closing of the Mortgage Loan, the A Note is sold to

another investment bank, international powerhouse Bigg, Whigg & Company, Inc. (“Bigg

Whigg”). Bigg Whigg intends to include the A Note in its upcoming securitization, the Bigg

Whigg Commercial Mortgage Pass-Through Certificates, Series 2002-BIG1 (the

“Securitization”). The securitized pool will contain a number of smaller loans and a handful of

other large loans similar to the Mortgage Loan. Bigg Whigg is planning on issuing these

securities off of a shelf, using its trusty depositor entity, which will purchase the A Note from

Risk Taker pursuant to a Mortgage Loan Purchase Agreement (the “MLPA”). Risk Taker and its

counsel review and discuss the representations and warranties Risk Taker is required to make
concerning the Mortgage Loan contained in the MLPA (and which will be mirrored in the Co-Lender Agreement with respect to the B Note). The MLPA for the A Note is executed by Risk Taker and the depositor. So far, it is all-systems-go with the 2002-BIG1 Securitization.

At closing, the 2002-BIG1 Securitization is a $1 billion plus pool of commercial and multifamily mortgage loans, tranched from the “AAA” rated Class A bonds, down to the unrated Class P bonds (the “Subordinated Bonds”), which occupy the pool’s “first loss” position and represent roughly 2% of the capital structure. The trust also issued a substantial amount of interest-only bonds (the “I/O Strip”), about $10 million of which were purchased by Risk Taker. Masterful Loan Servicing, Inc. (“Masterful Servicing”), a highly-respected loan servicer, purchased the master servicing rights for the Securitization pool and will act as master servicer under the Pooling and Servicing Agreement (the “PSA”) for the Securitization.

Really Special Loan Servicing, Inc. (“Really Special”), a hard-nosed, no-nonsense, loan servicer specializing in troubled assets, bought the Subordinated Bonds at a deep discount and is named special servicer for the pool. Under the PSA, Really Special is, at least initially, also the “Operating Advisor.” As operating advisor, Really Special will have certain approval rights over actions to be taken with respect to the bonds issued in the Securitization. Really Special financed its purchase of the Subordinated Bonds in this transaction, in part with a line of credit provided by Risk Taker. The line of credit is secured by a lien on Really Special’s ownership position in the Subordinated Bonds.

Lastly, in order that it might continue to nurture its relationship with No-Fault, Risk Taker has retained a primary servicing relationship, working as a subservicer for Masterful Servicing with respect to the Mortgage Loan. The arrangement between Risk Taker and Masterful Servicing for subservicing is spelled out in a Subservicing Agreement between Risk Taker and Masterful Servicing.


Risk Taker ultimately manages to sell its interest under the B Note to a European pension fund it advises, the Naïve Pension Fund (“Naïve Pension”). Naïve Pension negotiates no substantive changes into the Co-Lender Agreement. The B Note is, for the sake of convenience, serviced by Masterful Servicing (who is happy to increase its fee for this additional service) pursuant to special provisions in the PSA. Pursuant to the Co-Lender Agreement, Naïve Pension will have certain rights as holder of the B Note to appoint a Special Servicer with respect to the Mortgage Loan and to direct certain actions of the Special Servicer with respect to the Mortgage Loan. As permitted in the PSA and the Co-Lender Agreement, Naïve Pension appoints Really Special as its special servicer for the Mortgage Loan.

4. Sale of the Mezzanine Loan.

Following the closing of the initial financing, Risk Taker also manages to place the lion’s share of the Mezzanine Loan—a $30 million senior tranche (the “Senior Mezzanine Debt”)—with MegaLeverage Opportunity Fund, LLC (“MegaLeverage”), a fund specializing in
high risk mezzanine debt. MegaLeverage financed its purchase of the Senior Mezzanine Debt through a warehouse facility (the “Warehouse Facility”) provided by Risk Taker. At the end of the day, Risk Taker retains the balance of the Mezzanine Loan—the subordinated (and riskiest) $10 million tranche (the “Subordinate Mezzanine Debt”)—as a principal investment. As part of the sale of the Mezzanine Loan, the rating agencies require that MegaLeverage and Risk Taker, as holders of the Mezzanine Loan, enter into a standard, “industry” form of intercreditor agreement (the “Mezzanine Intercreditor Agreement”) with the trustee of the 2002-BIG1 Securitization. For the most part, as between MegaLeverage and Risk Taker, MegaLeverage is given full control over the Mezzanine Loan under the Mezzanine Intercreditor Agreement.

In the weeks following the closing of the Mortgage Loan and the Mezzanine Loan, the principal cast of characters in the securitization is as follows:

<table>
<thead>
<tr>
<th>Party</th>
<th>Role in Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Taker</td>
<td>Originating Lender; Mezzanine Participant’s and Really Special’s Warehouse Lender and holder of the Subordinate Mezzanine Debt</td>
</tr>
<tr>
<td>Bigg Whig</td>
<td>Underwriter for the Securitization</td>
</tr>
<tr>
<td>Masterful Servicing</td>
<td>Master Servicer for the Securitization and servicer of Naïve Pension’s B-Note</td>
</tr>
<tr>
<td>Really Special</td>
<td>Special Servicer for the Securitization (also appointed as Special Servicer for the Mortgage Loan by Naïve Pension)</td>
</tr>
<tr>
<td>Naïve Pension</td>
<td>Holder of the B-Note</td>
</tr>
<tr>
<td>MegaLeverage</td>
<td>Holder of the Senior Mezzanine Debt</td>
</tr>
</tbody>
</table>

The capital structure of with respect to the Mortgage Loan settled in as follows:

- No-Fault’s Equity in the Property: $50 million
- Risk Taker’s Retained Subordinate Mezzanine Debt: $10 million
- MegaLeverage’s Senior Mezzanine Debt: $30 million
- Naïve Pension’s B Note: $50 million
- Securitized A Note: $140 million
- Total: $280 million
C. **Endgame.**

On a dark and stormy night, the largest single tenant at the Property, Bogus Electronics, Inc. (“Bogus”), filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code. Five days later, on the next payment date under the Mortgage Loan, the Borrower makes the scheduled payment of principal and interest, but fails to make its required payment to the tenant improvement and leasing commission reserve. Even without Bogus, the Property could probably continue to generate enough cash flow to cover scheduled principal and interest payments under the Mortgage Loan, but it is unlikely that such cash flow will be sufficient to fund reserves for tenant improvements, leasing commissions or capital expenditures at contractual levels.

Uncertainty is the watchword for this project in the market. It’s far from clear whether Bogus will assume or reject its lease at the Property in bankruptcy. If Bogus rejects its lease, it is also not clear how easily and at what rate the Bogus space can be re-leased. Maybe someone could do a better job than NF Manager and the rest of the No-Fault team in managing the Property but then again, maybe not?

Thirty days later, as the Borrower shorts the Mortgage Loan tenant improvement and leasing commission reserve account for the second time, our principal players are getting together with their counsel to consider what to do next. Let’s listen in on what’s discussed:

1. **Masterful Servicing’s Offices.**

Though Masterful Servicing’s servicing fee for the Securitization is only two basis points, it is making serious money from the float generated by the scheduled monthly payments on the Mortgage Loan (incidentally, the largest in the pool) from the time such payments are submitted by the Borrower into Masterful Servicing’s collection account until Masterful Servicing is required to deposit those funds into the distribution account for the certificateholders under the PSA. On the one hand, if the Mortgage Loan was to default with respect to the principal and interest portion of the scheduled monthly payments, the interruption in the float to Masterful Servicing would be significant, but that would probably be offset by the advance interest Masterful Servicing could earn off of principal and interest advances. On the other hand, if the default occurred only as to the tenant improvement reserve portion of the scheduled monthly payments, Masterful Servicing might not have the ability to advance over that amount. Moreover, even if Masterful Servicing could advance such amounts and collect advance interest, perhaps such advances might not be ultimately recoverable if the property is really underwater (unlikely, but possible). At that point, Masterful Servicing would be obliged to shut off the spigot.

There has been a default under the Mortgage Loan—that seems straightforward enough. But the Borrower is acting as if everything should continue as usual, even as it submits a proposal to Masterful Servicing requesting that the amounts which Borrower is currently required to fund into the reserves be reduced. On the one hand, counsel is advising Masterful Servicing that upon the occurrence of a default under the Mortgage Loan, it should (as directed
by the PSA) declare a “Servicing Transfer Event” to have occurred and transfer the servicing of the Mortgage Loan to Really Special, whose job, after all, is to deal with troubled credits. Counsel also reminds Masterful Servicing that if the Borrower continues to short the Mortgage Loan’s waterfall, the servicing standard contained in the PSA may be read to require Masterful Servicing to transfer the servicing to Really Special, and on top of that, the definition of “Servicing Transfer Event” provides that if a borrower under a loan in the pool is delinquent in making a required payment for more than sixty days, a Special Servicing Transfer Event will be deemed to have occurred. On the other hand, the Borrower is assuring Masterful Servicing that “things will be fine next month”; that they’ll make up the missed payment; that under the circumstances “the waiver makes sense”; that “Bogus is good for the money”; that the bankruptcy proceeding will undoubtedly result in the reaffirmation of the lease by Bogus and reversal of the reserve shortfall within the next thirty days. Indeed, because Bogus will be affirming the lease in bankruptcy, overall levels of reserves can actually be reduced and this is simply anticipating that event!

Masterful Servicing carefully weighs its options. The Masterful Servicing portfolio manager responsible for the 2002-BIG1 Securitization is called into the vice president of portfolio management’s office. “If we declare a Special Servicing Transfer Event so early,” observes the portfolio manager, “the servicing of this Loan will be transferred to Really Special. At that point, the biggest loan in the pool has gone down, and we undoubtedly offend Bigg Whigg and Risk Taker, who have used us as master servicer on eight of their last ten deals.” She reminds her boss that both bankers have been counseling restraint, No-Fault is a big customer of theirs, and a declaration of default will irritate everyone and may cause the rating agencies to review other No-Fault deals and cause bond buyers to get shy about No-Fault concentrations. Also, Masterful Servicing’s life is not going to be made better if it gets a reputation with Bigg Whigg and other powerful underwriters for pulling the trigger too early on good customers. On the other hand, she reminds the boss that Masterful Servicing has a superb reputation among bond buyers and, if it doesn’t act, the bond holders may be ballistic. So Masterful Servicing reaches out to Risk Taker and Bigg Whigg and seeks assurances from No-Fault. For the moment, nothing happens.

2. **Really Special’s Offices.**

Over at Really Special, their initial reaction is to begin salivating for the Mortgage Loan. “If we get the servicing on the No-Fault loan,” observes an analyst at Really Special, “not only are we in a position to protect our investment in the subordinated bonds and Naïve Pension’s investment in the B Note, but we’re looking at some significant fees.” Really Special’s special servicing fee is about ten times Masterful Servicing’s master servicing fee, and Really Special is entitled to a large liquidation fee on the sale of the Mortgage Loan following foreclosure, or a workout fee for restoring the Mortgage Loan to performing status. The home run, of course, would be for Really Special to get control of the Mortgage Loan, to earn a workout fee for restoring the Mortgage Loan to performing status, and to have the Borrower pay these extra fees from Property cash flow, all the while fully protecting the value of Really Special’s first loss position in the Subordinated Bonds and Naïve Pension’s interest in the B
Note. Someone at Really Special suggests that Really Special’s initial response should be to begin saber-rattling, and to demand that Masterful Servicing declare a Special Servicing Transfer Event and immediately transfer servicing of the Mortgage Loan to Really Special. Maybe in future discussions with Masterful Servicing, Really Special should make it clear that if Masterful Servicing breaches the servicing transfer event provisions under the PSA, Really Special is prepared to make a big stink about it, including demanding that the rating agencies reconsider their high quality master servicer rating for Masterful Servicing?

On the other hand, it’s blindingly obvious to Really Special that if the Mortgage Loan goes down (or even if nothing happens for several months) the realized losses or appraisal reduction could cause a one hundred percent loss in its Subordinated Bond position not to mention the loss to Naïve Pension’s interest in the B Note. If that occurs, the next most subordinated class of bondholder (the “Slightly Less Subordinated Bondholder”) would succeed to Really Special’s position as most subordinate class of bondholder, and under the PSA, will be able to select a new Operating Advisor. At that point, Naïve Pension would also probably be unseated as the controlling holder of the B Note. Everyone at Really Special is keenly aware that the new Operating Advisor would have the right to remove Really Special as special servicer and replace it with another. To Really Special, that risk represents a double-whammy of loss of principal and loss of special servicing income, although one of the analysts astutely points out that the special servicing fees paid to Really Special when it owns the Subordinated Bonds are effectively a wash inasmuch as those fees are being paid by the certificateholders. Nonetheless, the consensus at Really Special is that control over the special servicing for the Securitization is still of critical importance because in the event of a loss on the Subordinated Bonds, Really Special is still working for those special servicing fees.

Next, someone at Really Special suggests that maybe Really Special should consider supporting Masterful Servicing’s view that a Special Servicing Transfer Event has not occurred, but only if that will delay the appraisal reduction process. The servicing transfer would trigger an “Appraisal Event” under the PSA. While it probably wouldn’t directly affect control over the Subordinated Bonds, under these circumstances, it would certainly reduce the dollar amount of Masterful Servicing’s advancing obligation with respect to the Mortgage Loan—and the amount of such appraisal reduction would be borne squarely by the Subordinated Bonds (not to mention the consequent reduction in Really Special’s special servicing fees). Maybe, in the meantime, Really Special can analyze the feasibility of purchasing the bonds from the Slightly Less Subordinate Bondholder? “Yeah,” observes a Really Special vice president, “we sure as heck better build a relationship with the majority bondholders of the next couple of senior classes in a hurry.” Finally, someone remembers that Risk Taker is acting as the subservicer for the Mortgage Loan and one of the head honchos at Risk Taker and No-Fault’s president will be meeting later this week for their usual Friday, two o’clock tee time. “If this is going to get ugly,” remarks the senior vice president of asset management at Really Special, “we better exercise any rights we may have to cut off Risk Taker as subservicer in a hurry.” Everyone at Really Special suspects that anything said to Risk Taker may get directly back to No-Fault, and no matter who wins the pull and tug over servicing the Mortgage Loan, a back channel to No-Fault is not a good idea. Really Special sends counsel scurrying off to confirm
that under the PSA, the special servicer has the right to terminate the subservicer. In addition, Really Special’s counsel ponders litigation strategy, should things come to that. Will information flowing to the primary servicer and the rating agencies have any impact on (or in the worst case, destroy) attorney-client privilege between Really Special and counsel?

On a separate track, Really Special is beginning to wonder whether, if push comes to shove, it can cause Masterful Servicing to require that the Mortgage Loan be repurchased by Bigg Whigg’s depositor-entity under the PSA, and ultimately, by Risk Taker under the MLPA. Of course, everyone at Really Special knows it would not earn any liquidation fees if the Mortgage Loan were put back to Risk Taker, but at least they’d be able to get par value for the Mortgage Loan to protect their principal investment in the Subordinate Bonds and Naïve Pension’s investment in the B Note. Undaunted, Really Special’s orders to counsel are to scour the PSA and the MLPA to see whether there is a basis for a credible put. Counsel is very interested in the representation in the MLPA concerning origination of the Mortgage Loan in accordance with the “standard industry practice.” It’s common knowledge that No-Fault has a reputation in the industry for being a bad borrower, going to the bankruptcy court innumerable times over the past decade. Also, someone at Really Special recalls that there may have been some financial information provided to Risk Taker prior to the Securitization that indicated Bogus might go into bankruptcy; Risk Taker had, after all, been one of the investment banks underwriting Bogus’ IPO last year. Suspicions are aroused at Really Special. What if Risk Taker originated the Mortgage Loan knowing, for instance, that the viability of the tenants on the rent roll for the Property was suspect, but figured that it could dump the loan into securitization before those facts came to life? Really Special directs counsel to investigate these issues immediately and prepares to put the parties to the Securitization on notice that the Mortgage Loan may be put back to Bigg Whigg and Risk Taker.

3. MegaLeverage’s Midtown Offices.

In midtown, at MegaLeverage’s offices, the first call goes out to its counsel. “Can we really execute on the equity pledge securing our senior mezzanine position quickly, like you told us when we closed the loan?” asks MegaLeverage’s investment officer responsible for the purchase of this position. MegaLeverage’s counsel begins to prevaricate because, having done dozens of these mezzanine loans and mezzanine loan participations over the years, he never actually had to enforce one. With some trepidation, counsel does its best to explain that, according to the Mezzanine Loan documents and their legal research, the mezzanine lender can declare a default for any event that constitutes an event of default under the Mortgage Loan Documents, and, counsel believes (but perhaps is not entirely certain) that failure by the Borrower to fund the reserves on the last payment date under the Mortgage Loan was such an event of default. In a conference call to MegaLeverage, the lead partner at MegaLeverage’s law firm raises another issue: “You should also be aware that enforcing mezzanine loan documents can expose you to lender liability claims for dominating the borrower’s business. You know, most mezzanine loan documents—and these are no exception—are fairly intrusive.” Counsel then reminds MegaLeverage that it cannot be absolutely sure that the Borrower’s failure to adequately fund those reserves would give rise to a Mezzanine Loan default because there has, to
date, been no declaration by any of the parties to the Securitization of an event of default under the Mortgage Loan. “By the way,” counsel goes on to advise MegaLeverage, “we also need to check the UCC, which governs the security interest in securities and intangibles like the pledge of equity securing your position. Now let’s see, was it Article 8 or Article 9 under which the security interest was created…”

A day or so later, counsel phones MegaLeverage to explain that a sale of the pledged equity can be engineered under the UCC. The catch is that such a sale under the UCC requires notice not only to Risk Taker as the holder of the Subordinate Mezzanine Debt, but just about every party with an interest in the Mezzanine Loan and will consume a lot of time—time that MegaLeverage probably doesn’t have. However, even if MegaLeverage moved to take No-Fault’s equity in the Borrower, they would likely face robust efforts by No-Fault to impede such an effort (including, possible, the aforementioned lender liability claims of dominating the borrower’s business). Counsel then looks back over the Mezzanine Intercreditor Agreement to discern whether that will impact the analysis. If a default is declared under the Mortgage Loan, the clock begins to run against MegaLeverage with respect to cure rights. Additionally, MegaLeverage also has to confront the reality that to exercise its remedies under the Mezzanine Loan and Mezzanine Intercreditor Agreement, is to do no better than step into the shoes of the Borrower, inheriting the legacy of Borrower’s defaults under the Mortgage Loan. MegaLeverage begins to look for a source of funding to cure any Mortgage Loan defaults should it have to step in.

Not only does MegaLeverage need to identify new capital (and quickly), but has to pay attention to its other financing arrangements. MegaLeverage’s counsel points out that, as a practical matter, under the terms of the Warehouse Facility documents, Risk Taker may be in a position to call for payment at any time. That conduct may be made more likely by MegaLeverage taking an aggressive stance to enforce its remedies under the Mezzanine Loan documents and the Mezzanine Intercreditor Agreement. Indeed, there may be some benefit in trying to convince Risk Taker that Risk Taker’s Subordinate Mezzanine Debt position is stable. Perhaps the better course of action for MegaLeverage is to work behind the scenes with No-Fault, and (at least in the foreseeable future) to forego exercising its remedies under the Mezzanine Loan documents and the Mezzanine Intercreditor Agreement. Yet, sitting on those remedies would mean that cure periods available to MegaLeverage may expire, and opportunities to reposition the project and bring in better management may be lost. All things considered, the folks at MegaLeverage decide they will wait and see who makes the first move and what happens next.


Everyone is in a tizzy over at Naïve Pension. No one is telling them anything, but they know something’s wrong. Naïve Pension and its counsel are now fretting over the terms of the Co-Lender Agreement Naïve Pension assumed at closing, which prohibits it from taking any action with respect to the B Note prior to the Mortgage Loan being specially serviced. Naïve Pension’s counsel informs it that Naïve Pension has absolutely no ability to do anything except
whine and pout, unless, of course, they choose to buy the A Note, which they may do at par and in accordance with the Co-Lender Agreement and PSA. Someone at Naïve Pension mumbles about “throwing good money after bad,” and what are they going to tell them at headquarters. Naïve Pension’s top executive in North America decides that “there is simply nothing to do at this juncture, other than hope that this whole problem goes away.” Ultimately, Naïve Pension decides to make it absolutely clear to Risk Taker and Bigg Whigg that if Naïve Pension takes a loss on this transaction, there will be hell to pay.


Heads will roll at Bigg Whigg if the Mortgage Loan goes into the tank so soon after the pool closed. Bigg Whigg has a reputation in the industry as a top-tier underwriter. The consensus among market players is that all of its loans are quality product. It would be front page news in the trade papers if the largest loan in 2002-BIG1 goes down so soon. Bigg Whigg wants nothing to do with workouts and restructurings; it wants this Mortgage Loan gone if it’s going to be any problem and its counsel is busily studying the MLPA under which it acquired the Mortgage Loan from Risk Taker.

Bigg Whigg’s lawyers are looking at the same “standard industry practice” representation and warranty that Really Special’s counsel is analyzing, but careful scrutiny is being given to each and every other provision of MLPA which might possibly give rise to a put. One thought is that, even if the put is merely colorable, Risk Taker might be willing to take back the Mortgage Loan to avoid the business ramifications of such a large loan going bad so soon. However, as one of the bankers at Bigg Whigg is quick to point out, putting such a large Mortgage Loan back to the originator so early in the deal will have a devastating impact on the yield of the I/O Strip (yield on the other classes of bonds will also suffer, though not to the same degree). These I/O Strips are typically purchased by “good” customers with Bigg Whigg brand loyalty. Certainly, such a traumatic hit to their yield so early in the game would sour that relationship (to say the least).

“At closing,” notes one of the Bigg Whigg bankers, “Risk Taker was into the I/O strips for at least $10 million. No way they are just going to roll over and agree to buy this loan back—especially when you consider that they’ll not only have to shell out the money for the repurchase of the loan, but they will be taking a huge hit on their I/O investment as well.” Bigg Whigg’s counsel chimes in that maybe the REMIC rules can work in their favor in this situation. Instead of being strong-armed into repurchasing the Mortgage Loan, Risk Taker might be persuaded to substitute a similar mortgage loan (a “qualifying mortgage loan” in REMIC parlance) in place of the No-Fault Mortgage Loan. Tax counsel for Bigg Whigg notes that as long as it is within two years of the “start-up” date of the pool, a substitution for this “defective obligation” is OK. Under that scenario, the yield to the bondholders might be preserved and Risk Taker would be free to workout the No-Fault Mortgage Loan once pulled from the Securitization. For the moment, it looks like a viable option (assuming, of course, that Risk Taker can afford to hold the Mortgage Loan on its books while working it out). But certainly,
until the situation clarifies, Bigg Whigg wants to maintain the status quo and warns the parties to the Securitization that it will not take lightly precipitous actions taken by any of them.

6. **Risk Taker’s Offices.**

High above Metropolitania, in one of Risk Taker’s conference rooms, Risk Taker’s counsel is carefully examining the offering materials for the 2002-BIG1 transaction to determine whether the disclosures made by Risk Taker were sufficient, or whether such disclosures contain any material misstatements or omissions. Risk Taker’s counsel is also reviewing the various indemnification agreements and certifications that Bigg Whigg required Risk Taker to sign when it sold the Mortgage Loan to Bigg Whigg’s depositor-entity, “just in case.” The senior partner at the law firm that represented Risk Taker in the sale of the Mortgage Loan is also pulling out the 10b-5 letter that the firm delivered in connection with its representation of Risk Taker in the Securitization and is starting to wonder about the firm’s liability.

The key issues for Risk Taker begin to surface. What did Risk Taker know about Bogus prior to the Securitization? Was the disclosure about the risk of high tech IPOs adequate? If Risk Taker is faced with a credible put, will it have the money to repurchase the Mortgage Loan? Can it get financing for that purpose? Or does Risk Taker have any loans in its inventory which would be an acceptable substitute for the Mortgage Loan? While it might be possible to control the behavior of Really Special because of the complex business relationship between Really Special, Risk Taker and Bigg Whigg, a more senior class of bondholders might take a more aggressive view as to the inadequacy of disclosure in the offering materials. Risk Taker decides not to push back too hard on the No-Fault issue.

Risk Taker also takes inventory of whether its position under the Warehouse Facility with MegaLeverage is secure. Obviously, it’s not. Risk Taker’s counsel advises Risk Taker that there is a marked-to-market margin provision under the Warehouse Facility loan documents and Risk Taker can value the collateral and demand a substantial paydown. If the margin payment is not made, it can foreclose upon the Senior Mezzanine Debt. The investment bankers at Risk Taker muse that it’s unlikely that MegaLeverage has the capital necessary to meet the margin call easily and, at the very least, a dispute may ensue over Risk Taker’s exercise of remedies on the Warehouse Facility and, at worst, it may trigger cross defaults amongst other MegaLeverage warehouse facilities. Everyone’s heads hurt thinking about the complexities of that development.

7. **No-Fault’s Offices.**

No-Fault has a problem, but not a problem they haven’t seen or heard of in the past. Sure, everyone at No-Fault had been aware of the Bogus problem for some time, but being developers and being optimistic, no one expected Bogus would really go in to bankruptcy (at least, not this early). Hopes had been high at No-Fault that by the time Bogus began to tip over, demand for space at the Property would be high and a Bogus bankruptcy wouldn’t be that big of a deal. Now it is. No-Fault’s counsel has advised No-Fault of all of the security arrangements
encumbering its positions. The permutations of potential exercise of remedies by the various lenders and secured parties is mind-numbing…but no one is doing anything at the moment. No-Fault speculates that its “solid” reputation will hold it in good stead and everyone will stand still and see what No-Fault’s first move will be. No-Fault’s counsel confirms that there is no direct recourse to No-Fault under the Mortgage Loan documents except for No-Fault’s guaranty of certain acts, chief among them fraud (and, by God, this couldn’t be fraud, could it?).

8. The Slightly Less Subordinated Bondholder’s Counsel’s Offices.

Recognizing that they are (as they say in the Bush administration) a “heartbeat away” from being the controlling class and having the ability under the PSA to select the operating advisor (and, more importantly, the special servicer), representatives of the Slightly Less Subordinated Bondholder meet with counsel. The Slightly Less Subordinated Bondholder view is that Really Special is trying to hold on to the control of the most subordinate bonds (and therefore, the special servicing) and its relationship with the Borrower in a continual victory of optimism over common sense. Consequently, in furtherance of its plans to strip Really Special of its control rights over the operating advisor, the Slightly Less Subordinated Bondholder directs its counsel to draft, but not yet deliver, a letter to Masterful Servicing demanding that the appraisal reduction process be commenced immediately. The Slightly Less Subordinated Bondholder decides to keep the demand letter in its hip pocket, but at the ready, pending the next move of Really Special.


The surveillance teams at the rating agencies rating the 2002-BIG1 pool have gotten wind of the problem with the Mortgage Loan. Masterful Servicing has dutifully reported (through required surveillance reporting under the PSA) the bankruptcy of Bogus and the consequent default by No-Fault. The rating agencies are demanding information in order to assist them in re-evaluating the ratings assigned to the pool.

Respective counsel have, however, advised Masterful Servicing and Really Special that disclosure to the rating agencies may occasion some issues with respect to attorney-client privilege in the event of litigation with No-Fault. On the other hand, there is concern that the failure to make such disclosure might violate the servicing standard in the PSA applicable to both Masterful Servicing and Really Special. Without data, the rating agencies may be left with no choice but to downgrade the ratings assigned to the pool. Such a downgrade would have serious adverse consequences for Bigg Whigg as the underwriter (loan defaults in its pools and, even worse, downgrades of certificates, are extremely bad press). Moreover, a number of investors in the 2002-BIG1 pool may have trouble maintaining their positions in the pool if the investment grade rating on certain certificates is lost, occasioning forced sales, losses and hostility and resentment toward Bigg Whigg as an underwriter of quality credit. Decision time is drawing near.

D. The Next Move.
Limbo. Everyone in the transaction is uncertain and grumpy, and no one has made a move. Almost no one has a clear motive and virtually everyone has incentives which conflict with other parties in the transaction. Some, if not most, are self-conflicted. Pursuing one goal may expose them to risk or loss along another axis.

This is, of course, a work of speculative fiction. The purpose is to make a point about the complexity of interests amongst the many parties who are a part of the securitization business and a point about the very vulnerability of complexity itself. Securitization is a sophisticated construct designed to achieve very specific objectives. The mechanism is a marvel. It is worthy of admiration. But, like most complex systems, it is subject to the criticism that it is not robust. We have just stressed this deal. What happens next is your guess. Want to speculate?